BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of SAN JOSE WATER COMPANY (U 168 W) for an Order Approving the Sale of the Main Office under Section 851 and Authorizing the Investment of the Sale Proceeds under Section 790.	Application 07-01-035 (Filed January 22, 2007)

OPENING BRIEF OF THE DIVISION OF RATEPAYER ADVOCATES

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TABLE OF CONTENTS

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I. SUMMARY AND RECOMMENDATIONS

1. San Jose Water Company's (SJWC) application for the sale of its Main Office, purchase of a new Main Office building, and purchase of the 1265 Bascom Avenue building in San Jose -- where it is currently leasing space from its affiliate San Jose land Company (SJLC) -- should be denied because remodeling the current Main Office and leasing additional space at 1265 Bascom Avenue (Base Case) is the least cost option based on the net present value (NPV) analysis of future revenue requirements.
2. DRA points out that SJWC's proposed Base Case, which involves renovating its current Main Office building and leasing an additional 3,980 square feet (sf) of space from its affiliate SJLC, provides more space than is actually necessary to accommodate the six employees hired since SJWC's last General Rate Case (GRC) and anticipated future growth. This is especially true since separate and apart from the Base Case, SJWC will be acquiring 2,850 sf of additional space in its 1251 Bascom Avenue building when it moves store items to its Will

Wool building in San Jose, which is under construction. Upon subtracting the 2,850 sf of space from the 3,980 sf of space requested in the Base Case, SJWC only needs to lease an additional 1,130 sf of space at 1265 Bascom Avenue to accommodate the six new employees hired after its last GRC and future growth.

3. SJWC has been leasing the second floor of the 1265 Bascom Avenue building from its affiliate SJLC since 1999 to accommodate employees from its regulated operations. The evidence in this proceeding shows that the lease of the additional space at 1265 Bascom Avenue, coupled with the space freed up at 1251 Bascom Avenue when the store items are moved to Will Wool, would have solved SJWC's current need for additional space and future growth.

4. SJWC misled the Commission by failing to disclose the fact that it had purchased the 1265 Bascom Avenue building in May 2007 resulting in a violation of Rule 1.1 of the Commission's Rules of Practice and Procedure. DRA discovered this information for the first time during evidentiary hearings when a SJWC witness testified to that effect during cross-examination. SJWC had numerous opportunities to disclose this material fact to DRA, for example during discovery throughout the proceeding prior to hearings, by amending its application, during the last PHC in October 2007, or during DRA's last site visit in November 2007, but failed to do so. In essence, SJWC has gone ahead and attempted to implement Alternative 2 prior to a Commission decision on this matter. SJWC's purchase of the building as early as May 2007 obviously calls into question whether the Base Case and Alternative 1 are realistic options. At a minimum, SJWC should have amended its application to reflect reality, rather than disclose this matter as a result of cross examination during hearings. SJWC should be subject to penalties for this Rule 1.1 violation.

5. The Commission should issue an order voiding SJWC' sales transaction with its affiliate SJLC for the 1265 Bascom Avenue building and order SJWC to lease only 1,130 sf of space on the first floor of the 1265 Bascom Avenue building for the market rate of $13.20 per sf per year. The Commission should approve only the leasing cost of the additional 1,130 sf of space at 1265 Bascom for ratemaking purposes. Should the Commission allow SJWC to purchase the 1265 Bascom Avenue building, DRA recommends that the affiliate transaction rule of "lower of cost or market" be applied for the purchase price of this building and the building acquisition cost be limited to $2.7 million (original cost of $3.6 less .9 million for depreciation) which is the book cost of its affiliate SJLC.
6. Should the Commission allow SJWC to continue to lease the second floor of the Bascom Avenue building from its affiliate SJLC (for example if its purchase of 1265 Bascom Avenue is void), SJWC should renegotiate the lease with its affiliate since it has been paying almost three times the market rent for space in the area.
7. SJWC should file Section 851 applications for the five properties that it transferred to its affiliate SJLC without Commission authorization.

II. BACKGROUND

On January 22, 2007, SJWC filed Application (A.) 07-01-035 pursuant to Section 851 of the Public Utilities Code[1] seeking Commission approval to sell its Main Office for $4 million.[2] SJWC's Main Office, located at 374 West Santa Clara Street in downtown San Jose, is designated as an historic landmark. It

[1] All references to Sections are to the Public Utilities Code unless otherwise specified.

[2] SJWC also requested Commission authorization to reinvest the net proceeds of the sale in infrastructure under Section 790. On September 13, 2007, the Assigned Commissioner issued a ruling finding that the property to be sold (the Main Office) was still necessary and useful utility property, therefore, any proceeds from the sale are not eligible for reinvestment pursuant to Section 790.

consists of corporate headquarters, a walk-in commercial office and billing department. All engineering, operations, maintenance, water quality, and personnel functions were moved to what is known as SJWC's Bascom Avenue Campus (Bascom Campus) over the years. The Bascom Campus consists of four buildings (1221A, 1221B, 1256 and 1265 Bascom Avenue, San Jose). SJWC owns the buildings located at 1221A, 1221B, and 1256 Bascom Avenue, while its affiliate SJLC owns the 1265 Bascom Avenue building. At the time it filed this application, SJWC was leasing the second floor of the 1265 Bascom Avenue building from its affiliate SJLC to accommodate some of its employees.

In its application, SJWC presented three alternatives for the Commission to consider: Base Case, Alternative 1 and Alternative 2.

1. Base Case involves renovating its current Main Office building and leasing an additional 3,980 sf of space from its affiliate SJLC at 1265 Bascom Avenue in San Jose.
2. Alternative 1 involves purchasing a new downtown building with 15,180 sf of space and leasing 10,000 sf of additional space at the first floor of 1265 Bascom Avenue building.
3. Alternative 2 involves purchasing a new downtown building at an estimated cost of $3.8 million and buying the 1265 Bascom Avenue building at $4.3 million from SJLC.

SJWC seeks Commission approval of Alternative 2 claiming that the historical status of its Main Office makes remodeling difficult and that it needs additional space to accommodate six new employees approved in its 2006 GRC and anticipated future growth.[3] (SJWC Application, p. 3) Subsequently, pursuant

[3] DRA acknowledges that the historical status of the building makes construction of internal and external modifications more difficult, but does not agree that those improvements would be more costly to ratepayers than the purchase of the new building. (DRA Exh. 1, p. 3) Moreover, SJWC's witness Giordano admitted during hearings that ADA requirements are grandfathered . (Transcript Vol. 1, pp. 65-66)

to Alternative 2, SJWC has negotiated to purchase the Chicago Title Insurance Company building, which has a gross square footage of 28,000 sf, located at 110 West Taylor Street in downtown San Jose for $6.7 million to use as its Main Office. (SJWC Exh. 2, Yoo p. 3) Although this price is $2.9 million above the original estimate of $3.8 million in SJWC's application, SJWC states that it will not request more than the original amount of $3.8 million in rate base at this time. (Transcript PHC 2, p. 42) As part of Alternative 2, SJWC also proposes to purchase the 1265 Bascom Avenue building where it currently leases the second floor from its affiliate SJLC. (SJWC Exh. 1, Yoo p. 7)[4]

DRA recommends that SJWC's request for Commission approval of Alternative 2 be denied because remodeling of the current Main Office and leasing of additional space at 1265 Bascom Avenue (Base Case) is the least cost option based on the NPV analysis of the future revenue requirements. SJWC had been leasing the second floor of the 1265 Bascom Avenue building from its affiliate SJLC until the purchase of the building in May 07 and has employees located there. SJWC could have easily leased additional space in the first floor of the 1265 Bascom Avenue building to accommodate the six additional employees approved in the last GRC, who already have been retained by SJWC, and future growth.

DRA's analysis of the three alternatives presented by SJWC shows that the Base Case is the least cost option to ratepayers and provides SJWC with more space than is actually necessary, which will be explained in detail below.

III. FINANCIAL ANALYSIS

SJWC hired CBRE Consulting (CBRE) to initiate a study on its office space needs. CBRE performed a Discounted Cash Flow (DCF)/NPV analysis of

[4] During evidentiary hearings, DRA discovered that SJWC purchased the 1265 Bascom Avenue building from its affiliate in May 2007 and failed to disclose this fact to DRA throughout this proceeding. (Reporter's Transcript Vol.1, pp. 58-61) This issue will be discussed in detail later in the brief. SJWC has also already purchased the Chicago Title Insurance Company building. (Reporter's Transcript Vol.1, pp. 60-61)

the Base Case, Alternative 1 and Alternative 2 using an analysis of the impact of cash flow on its shareholders with information from SJWC and financial evaluation by Steinberg Architects and Garden City Construction, Inc. (SJWC Exh. 1, Stein pp. 1-10) CBRE determined that the NPV of the cash flows for the three scenarios was $16.53 million for the Base Case, $17.84 million for Alternative 1, and $15.06 million for Alternative 2. Based on this analysis, CBRE found that SJWC's Alternative 2 is the least costly scenario. (SJWC Exh. 1, Stein p. 9) SJWC then computed the revenue requirements of $1.87 million for Alternative 2. (SJWC Exh. 1, Jensen p. 4)

A. SJWC Did Not Consider the Effects on its Ratepayers in its DCF/NPV Analysis

CBRE's DCF/NPV analysis is seriously flawed in material ways. First, CBRE failed to consider the revenue streams that would be provided to SJWC by ratepayers or the impact on rates. During hearings, Mr. Stein testified that "revenues from ratepayers were deliberately excluded from the cash flow analysis." (Transcript Vol. 2, p. 180; SJWC Exh. 4, p. 3). He also testified that in regard to all three alternatives, he did not factor in revenues from ratepayers. (Transcript Vol. 2, p. 180) Because the revenue streams collected from ratepayers are different for the Base Case, Alternative 1 and Alternative 2, SJWC's failure to include this invalidates its DCF analysis. (DRA Exh. 1, p.13)

Second, CBRE's DCF/NPV analysis is limited to SJWC's shareholders' perspective. Alternative 2, for example, SJWC assumed that shareholders would get the proceeds ($14.98 million) from the sale of the new Main Office building after 35 years. (SJWC Exh. 1 Stein p. 36) The company then reduced the NPV of cash flows for Alternative #2 for the resale value of the new Main Office building at the end of a 35 year life. SJWC's proposal, for shareholders to receive all of the proceeds from the sale of the Main Office, would deny any benefits from the transaction to its ratepayers.

However, when SJWC prepared a revenue requirement analysis from the ratepayers' perspective in response to a data request from DRA, the analysis shows that the Base Case is the least cost option for ratepayers and the best solution to SJWC's space problems. (DRA Exh. 8, Attachment A)

B. SJWC Did Not Compare Revenue Requirements Of All Three Alternatives

SJWC did not compare the impact of the revenue requirements for the Base Case, Alternative 1 and Alternative 2 or the effect of those revenue requirements on ratepayers over the life of the buildings. Instead, SJWC calculated the revenue requirements for Alternative 2 and determined that it would need a $1.8708 million contribution from its customers to finance the transaction during the first year. (SJWC Exh. 1, Jensen p. 4)

SJWC should have compared the NPV of revenue requirements for the Base Case, Alternative 1 and Alternative 2 over the life of the projects and then selected the alternative that produced the least revenue requirement impact on ratepayers. (DRA Exh. 1, p. 13)

C. SJWC's Revenue Requirement Analysis Contains Four Material Errors

1. SJWC Used The Wrong Net to Gross Multiplier In Its Analysis

The first error is that SJWC used the wrong Net to Gross multiplier in its analysis. SJWC should have used the Net to Gross multiplier for a rate base offset (1.4173) because SJWC is asking for a return on the purchase of the two buildings presented in Alternative 2 outside of a GRC. (DRA Exh. 2, p. 9 and 14) Instead, SJWC used the Net to Gross multiplier for a rate of return increase (1.69). (SJWC Exh. 1, Jensen Attachment A). As a result of using the wrong Net-to-Gross multiplier, SJWC artificially increased the revenue requirement. (DRA Exh. 1, p. 9; DRA Exh. 14)

The Net-to-Gross multiplier is developed to convert a net revenue requirement to a gross revenue requirement and is calculated from the adopted uncollectible rate, local franchise tax rate, California Corporate Franchise tax rate and Federal Income Tax rate. (Transcript Vol. 3, p. 376) In order to provide an increase in net revenues, the gross revenue requirements generally must be higher than the net revenue increase because the utility needs to pay income taxes and local franchise taxes and to provide for uncollectibles.

A rate increase may be attributable to an increase in expenses, rate base, or rate of return. Rate increases attributable to expenses are called expense offsets; rate increases attributable to rate base increases are called rate base offsets; and rate increases attributable to an insufficient rate of return result in a General Rate increase. The Net to Gross multiplier for each of the three cases is different because of the different tax treatment of each component of the rate increase. For example, a rate increase attributable to an increase in expenses does not increase the state and federal income tax liability and only results in a small increase in uncollectibles and local franchise tax. Therefore, the Net-to-Gross multiplier is almost one (1). (Transcript Vol. 3, p. 375)

A rate increase attributable to an increase in rate of return from a present rate of return to a higher adopted rate of return does not create any additional income tax deductions, therefore, the entire gross revenue requirement increase is taxable and the Net to Gross number of 1.69 is used as demonstrated in SJWC's last GRC. (Transcript Vol 3, p. 375)

The Net to Gross multiplier for a rate base offset such as in this proceeding falls somewhere between the Net to Gross multiplier for an expense offset and the Net to Gross multiplier for a rate of return change because rate base additions are funded through both debt and equity and the interest paid from the debt portion of the rate base addition is tax deductible. Therefore, the Net-to-Gross multiplier for the rate base offset falls between 1 to 1.69. (Transcript Vol. 3, p. 375) DRA demonstrates how the Net-to-Gross-multiplier should be calculated in its exhibits. (DRA Exh. 2, Attachment C; DRA Exh. 14)

SJWC used a net-to-gross multiplier of 1.69. This net-to-gross multiplier is used for net revenue changes attributable to the changes in rate of return. It is the same Net to Gross multiplier that SJWC used in its last GRC. (Transcript Vol 3, p. 375) The Net-to-Gross multiplier for the net revenue changes attributable to the changes in rate base for SJWC is 1.4173 because the rate base increase is funded through approximately 47.53% debt and 55.47% equity, and the interest payment for debt is tax deductible. The tax deduction of interest expenses reduces the Net to Gross multiplier to 1.4173. (DRA Exh. 2, p.9 and Attachment C; DRA Exh. 14) As shown in DRA Exh. 14, if SJWC's Net-to-Gross multiplier of 1.69 were used, it produces $14.60 more net revenues than needed for each $1,000 addition to rate base. (DRA Exh. 14)

SJWC's statement that Net-to-Gross number adopted in the GRC is the correct number is wrong. (SJWC Exh. 5, p. 2) The Net-to-Gross number is used to derive the gross revenues changes attributable to net revenue changes. It is a number derived from the adopted numbers such as uncollectible rate, local franchise tax rate, state and federal income tax rates and it is not an adopted number. (Transcript Vol. 3, p. 376)

D. SJWC Erroneously Took Depreciation On Net Plant After Depreciation

The second error in SJWC's revenue requirement calculation is that SJWC took depreciation on net plant after depreciation. Depreciation should be applied to gross plant not to net plant. Mr. Jensen admits that this is an error. (Transcript Vol. 2, p. 247; DRA Exh. 10, Attachment E)

E. SJWC Did Not Consider Deferred Taxes

The third error in SJWC's revenue requirement calculation is that SJWC did not consider the deferred taxes that would be available from the tax deferred 1031 property exchange SJWC is planning to use to defer capital gain taxes. The deferred capital gains tax should be deducted from rate base. Although SJWC's witness Mr. Jensen is not sure whether SJWC can meet the 1031 property exchange requirement that the transaction be completed within six months, he admits that if it does so the deferred capital gains tax should be deducted from rate base. (Transcript Vol. 2, pp. 244-246)

F. SJWC Failed To Escalate Lease Payments After The 10th Year

The fourth error in SJWC's revenue requirement calculation is that SJWC failed to escalate the lease payments for a new downtown Main Office building and 1265 Bascom Avenue building after the 10th year. Palle Jensen of SJWC admitted this error on the stand. (DRA Exh. 10; Transcript Vol 2, p. 246)

Because of the various errors discussed above, SJWC's DCF/NPV analysis is flawed and the Commission should reject the company's analysis.

G. Alternative 2 Is the Most Expensive Alternative While The Base Case Is The Least Cost Option

DRA had SJWC correct the errors discussed above and calculate a NPV of the revenue requirement analysis. DRA had SJWC re-run its cost/benefit analysis from the ratepayers' perspective by using the correct Net-to-Gross multiplier, 1.4173, and by reducing rate base for the deferred capital gain attributable to the 1031 property exchange that SJWC plans to use, as well as correcting the other errors mentioned above. (Exh. DRA Exh. 8, SJWC's Response Attachment A)

This corrected analysis of the NPV of the revenue requirements for the three alternatives revealed the following:

1. The revenue requirement for the Base Case is $ 7.16 million.
2. The revenue requirement for Alternative 1 is $10.80 million .
3. The revenue requirement for Alternative 2 is $12.36 million.

(DRA Exh. 2, p. 14)

This revenue requirement analysis is based on the original purchase price of $3.8 million for a New Main Office. However, as discussed immediately below, the purchase price is now $6.7 million. Although SJWC has stated that it is not seeking to recover more than the original purchase price of $3.8 million, DRA is concerned that SJWC will seek the difference ($2.9 million) in the near future.

SJWC's corrected revenue requirement analysis from the ratepayers' perspective based on the original purchase price of $3.8 million shows that the most inexpensive option for ratepayers is the Base Case and the most expensive option is Alternative 2 proposed by SJWC in this application. (DRA Exh. 2, Attachment A; DRA Exh. 3) Therefore, DRA recommends that the proposed sale of the existing Main Office and the purchase of the new downtown office and the 1265 Bascom Avenue building be denied.

H. The Increased Purchase Price From $3.8 Million To $6.7 Million Has A Negative Effect On Ratepayers

The original cash flow analysis was based on an estimated purchased price of $3.8 million for the new Main Office. (SJWC Exh. 1, Stein p.3) That negotiation, however, for the original building fell through and SJWC negotiated to purchase the Chicago Title Insurance Company building for $6.7 million. At the second PHC, SJWC stated that it will only seek a rate increase for $3.8 million of the purchase price of $6.7 million in this application. SJWC also stated that it would request the rate increase for the remaining portion of the investment through a separate application if SJWC can justify the extra space for its operations in the future. (Transcript PHC Vol. 2, p. 42) Although SJWC states that it does not intend to lease out the excess space in the Chicago Title Insurance building at this time, it is likely that SJWC will request the $2.9 million increase in purchase price in the near future. (Transcript PHC Vol. 2, p.433) Therefore, the economic justification study by SJWC should have included the full purchase price of $6.7 million.

SJWC indicates that there will be an additional cost of $2.3 million for construction/renovation and $76,000 for relocation to the Chicago Title Insurance Building. (DRA Exh. 1, p.15; Exh. 12, p. 1) When DRA performed a revenue requirement analysis using the $6.7 million price of the Chicago Title Insurance building, the NPV of the revenue requirement for the three alternatives was as follows:

1. $7.16 million for the Base Case.
2. $12.42 million for Alternative 1.
3. $16.40 million for Alternative 2.

(DRA Exh. 2, Attachment B; DRA Exh. 3)

Because of the substantial increase in the purchase price of the Chicago Title Insurance Building (from $3.8 million to $6.7 million), the Base Case is even more favorable and Alternative 2 is even more detrimental in terms of its effect on rates. The NPV of the revenue requirement for SJWC's proposed Alternative 2 has increased from $12.36 million (with the original $3.8 million purchase price) to $16.40 million dollars with the $6.7 million purchase price.

Based on the above, DRA recommends that the Commission reject SJWC's proposal to sell its Main Office and move to the new Chicago Title Insurance Building. DRA requests that the Commission order SJWC to keep the existing Main Office or look for a lower cost alternative instead of moving to the new Chicago Title Insurance building. (DRA Exh. 1, pp. 7-8)

I. The Commission Should Void SJWC's Purchase of the 1265 Bascom Avenue Building

At the evidentiary hearing, SJWC's witness Giordano stated that SJWC purchased the 1265 Bascom Avenue building from its affiliate SJLC in May 2007. (Transcript Vol. 1, p. 59) DRA believes that SJWC should have waited for the Commission's decision in this matter since the request to purchase the 1265 Bascom Avenue building is one of SJWC's requests in this proceeding. Instead, SJWC essentially went ahead with Alternative 2 without regard to the Commission's future decision or the costs to ratepayers.

SJWC only needs to lease 1,130 sf of additional space at 1265 Bascom Avenue building. Under a lease, SJWC would only acquire the amount of space it currently needs, not the whole building. SJWC's proposed Base Case indicates that it only needs 3,980 sf of additional space. During hearings, SJWC's witness Giordano testified that SJWC is increasing the sf of the store building it's constructing at Will Wool from 6,000 to 9,000 sf. (Transcript Vol. 1, pp.66-67) He also testified that SJWC will move items from 1251 Bascom Avenue to the new Will Wool building freeing up 2,850 sf of office space at the 1251 Bascom Avenue building. (Transcript Vol. 1, pp. 67-68) After taking into account the additional 2,850 sf available at 1251 Bascom Avenue, and subtracting that square footage from the 3,980 sf of space SJWC proposed to lease at 1265 Bascom Avenue in the Base Case, it becomes clear that SJWC only needs to lease 1,130 sf of additional space at 1265 Bascom Avenue building to meet its additional space needs.

Therefore DRA recommends that the Commission issue an order voiding SJWC' sales transaction with its affiliate SJLC for the 1265 Bascom Avenue building and order SJWC to lease only 1,130 sf of space on the first floor of the 1265 Bascom Avenue building for the market rate of $13.20 per sf per year.

Should the Commission allow SJWC to purchase the 1265 Bascom Avenue building, DRA recommends that the affiliate transaction rule of "lower of cost or market" be applied for the purchase price of this building and the building acquisition cost be limited to $2.7 million (original cost of $3.6 less .9 million for depreciation) which is the book value cost to its affiliate SJLC. SJLC acquired the 1265 Bascom Avenue building at $3,595,000 in 1998 (Response to RK-5, Attachment D p.1 of CBRE's Summary of Appraisal Report for 1265 Bascom Avenue Building) and the accumulated depreciation at 2.5% depreciation rate over the 10 year period would be 0.9 million. This would result in a book cost of $2.7

million. SJWC's request under Alternative 2 that the Commission approve the market value of $4.3 million for the acquisition cost of this building should be denied. (SJWC Exh. 1, p.6 of Stein's Testimony) The Commission should not allow SJWC's affiliate to profit $1.6 million from captive ratepayers.

The Commission has a long held policy of affiliate transactions between a utility and its subsidiary being governed by the "lower of cost or market" rule. In D.97-12-011, which authorized California Water Service Company to create a holding company, the Commission decision states that "Assets and goods transferred to the utility from an affiliate shall be at the lower of cost or market." This rule is to prevent utilities from self-dealing to maximize its profits through unnecessary sales and transfers of assets and services with its affiliates at artificially inflated prices. This is especially applicable to the 1265 Bascom Avenue building since SJWC has been leasing the second floor from its affiliate SJLC since 1999 and SJWC's ratepayers have been paying for the facilities at an inflated lease rate. (DRA Exh. 1, p.15)

J. Costs Should Be Included in Construction Work in Progress and Reviewed by DRA

If the Commission adopts DRA's recommendations and approves the remodeling of the Main Office, DRA recommends that the costs be included in a Construction Work in Progress (CWIP) memo account thereby accruing interest during construction. In addition, such project costs should be reviewed by DRA during the next GRC or when SJWC requests to include it in rate base.

K. SJWC's Proposed Rate Increase Is Inconsistent with the Rate Case Plan

DRA also points out that SJWC's proposed rate increase is not consistent with the Rate Case Plan (RCP) for water utilities.[5] The RCP allows water utilities

[5] D.07-05-062 issued May 24, 2007, makes significant changes to the Rate Case Plan (RCP) for Class A water utilities approved in D. 04-06-018, including adopting a new schedule for filing GRCs and requiring multi-district water utilities to eventually file a single GRC for all districts at the same time. However, the transition to this new schedule will be gradual and does not appear

to file a GRC every three years. SJWC just completed a GRC in 2006 and the new rates went into effect January 1, 2007. Requesting a selective offset rate increase for a project is not allowed under the RCP and is contrary to providing rate stability for the provision of water service to SJWC's ratepayers. In addition, granting rate increases in a piecemeal fashion is contrary to the objective of streamlining the rate case process set forth in the RCP and increases the Commission's workload. (DRA Exh. 1, p. 8)

IV. SPACE REQUIREMENTS

A. SJWC's Current And Future Space Needs Can Be Met With Its Available Inventory Of Space

The Base Case supporting SJWC's economic justification analysis includes 3,980 sf of additional office space to accommodate six new employees that were approved in the last GRC, and for future expansion. The six new employees have been working in the company for almost one year and each employee has his or her own office space. The amount of office space occupied by the six employees is 684 sf. (DRA Exh. 4, Response 7) [6]

The 1251 Bascom Avenue building is being used mostly for storage of materials. The available floor space is 5,700 sf. The building is being renovated to convert 2,850 sf of the storage space to office space. (Transcript Vol. 1, p. 81) The remaining 2,850 sf will continue to be used as storage space. The materials from the storage space in 1251 Bascom Avenue will be moved to the Will Wool building currently under construction at 2268 Will Wool Drive, San Jose, California.

to impact the substantive issues in this application.

[6] SJWC did not put page numbers on its response to this and other data requests, so the Response No. will be provided in lieu of the page no.

SJWC's witness Giordano testified that regardless of whatever alternative is approved, the Will Wool building will be constructed. That building will be 9,000 sf. There will also be 3,000 sf of warehouse space available in the Will Wool Building that will be used to transfer items from the 1251 Bascom Avenue building. Thus, apart from the Base Case, there will be 2,850 sf of office space available at 1251 Bascom Avenue in the near future. As a result of this action, the total space required by SJWC will be 1,130 sf calculated as below:

> Required in Base case: 3,980 sf for 6 staff approved in SJWC's last GRC and for future growth.
>
> Less, Office space at 1251 Bascom: 2,850 sf after moving items to Will Wool Building.
>
> Net Space Requirement: 1,130 sf

Approximately 10,000 sq. ft of floor space is available for lease on the 1st floor of the 1265 Bascom Avenue building. (Transcript Vol. 1, p. 82; DRA Exh. 7, p. 3) So, if additional space is needed, the 1,130 sf of additional space can be easily leased at 1265 Bascom Avenue. Thus, all of SJWC's current and future needs for office space can be accomplished by utilizing the currently or soon to be available inventory of office space. This will eliminate the need to replace the current 21,200 sf Main Office building with the 28,000 sf Chicago Title Insurance building.

B. SJWC's Proposed Space Requirements Are Inconsistent With The Company's Historical Customer or Employee Growth

A review of SJWC's customer growth from 2001 through third quarter 2007 indicates that SJWC's customer base has been roughly constant. The average year over year growth in customers has varied from .03% in 2002 to 0.7% in 3Q 2007. (DRA Exh. 12) The corresponding average annual growth in total employees for the same period has averaged 2.1% over the six year period. (DRA Exh. 13, Response 2) No evidence has been presented that demonstrates that such trends will change in the foreseeable future.

SJWC's Base Case indicates its current space utilization of 61,900 sf calculated as below:

Net space available before expansion:	61,900 sf
Add: 1265 Bascom Ave (1st Floor):	3,980 sf
Total space from SJWC Analysis:	65,880 sf
(SJWC Exh. 1, Stein p. 3, Table 1)	

In Alternative 1, SJWC will have total available space of 68,730 sf calculated as follows:

Total space from SJWC Analysis:	65,880 sf
(SJWC Exh. 1, Stein, p. 3)	
Plus: Space available at 1251 Bascom Ave:	2,850 sf
(Transcript Vol 1, p. 81)	
Total available space:	68,730 sf

In Alternative # 2, as filed in SJWC's application, the available space is the same as Alternative 1 (68,730 sf.).

However, since the filing of its application, SJWC has purchased the Chicago Title Insurance building pursuant to Alternative 2 resulting in total floor space available of 81,550 sf calculated as follows:

Total space from SJWC Analysis:	65,880 sf
(SJWC Exh. 1, Stein, p. 3)	
Plus: Space available at 1251 Bascom Ave:	2,850 sf
(Transcript Vol 1, p. 81)	
Plus: Chicago Title Insurance Building:	28,000 sf
(Transcript Vol. 1, P. 19 and Vol. 2, P. 198)	
Less: New Downtown Building:	15,180 sf
(SJWC Exh. 1, Stein, p. 3)	
Total available space for Alternative # 2:	81,550 sf

Under the Base Case, the actual net space currently available before expansion is 61,900 sf. The space available for Alternative 1 is 68,730 sf which is 6,870 sf or, 11% more than for the Base Case. Under Alternative 2, the space available is 81,550 sf which is 19,650 sf or, 32% more than the currently available space for the Base Case. The increase in available space over the Base Case for both alternatives is inconsistent with the historical growth in customer base or of employees at SJWC and are unnecessary.

C. SJWC Relocation Plans Will Result In Extremely Low Occupancy Of Space

SJWC currently has 67 employees at its main office. (SJWC Exh. 1, Yoo p. 2) The Main Office consists of corporate management, walk-in commercial office and billing department. Upon selling the Main Office, SJWC plans to relocate its employees to its various properties.

The Chicago Title Insurance building has a gross available area of 28,000 sf. SJWC indicated that it needs 15,180 sf of office space in its Alternative # 2. (SJWC Exh. 1, Stein, p.3) or, 54.2% of the Chicago Title Insurance building.

SJWC asserts that after relocating its employees to the Chicago Title Insurance Building, there will be 3,768 sf of excess office space available for later expansion. (DRA Exh. 4, Response 7) SJWC has indicated that it has no immediate plans to rent or lease the excess space in the building. (Transcript Vol. 1, P. 22)

SJWC plans to relocate 37 staff persons, mostly management personnel, to the Chicago Title Insurance Company building from its current Main Office building. Staff will consist of twenty management and regulatory staff, ten accounting staff and five customer service representatives. The space per employee in the new building will be 757 sf. [7] SJWC pointed out that the industry average for space allocation for employees varies from 70 sf for a clerk to 262 sf

[7] 28000 sf / 37 employees = 757 sf per employee

for an officer. SJWC proposed standards for space allocation for employees varies from 48 sf for a clerk to 380 sf for an officer. (DRA Exh. 4, p. 6-5) Clearly, this is an extremely high space allocation on a per employee basis.

V. AFFILIATE TRANSACTIONS AND UNAUTHORIZED PROPERTY TRANSFERS

A. SJWC Should Re-negotiate Its Lease Consistent With Market Rates

In September 1999, SJWC entered into a ten year lease with its affiliate, SJLC, to lease a portion of the 2nd floor of the 1265 Bascom Avenue building. The lease rate was $1.92 per sf per month. Under the terms of that lease, SJWC had the option of re-negotiating the lease on the same terms when additional space became available. (DRA Exh. 6, see 1.6(a)) In January 2000, SJWC replaced the September 1999 lease with a new lease expiring in 2010 for 11,800 sf of office space on the 2nd floor of the building. The base rates negotiated were $2.40 per sf per month. This rate was much higher than the rate in the 1999 lease. (Transcript Vol. 1, Pgs. 139, 140)) The current market rate for similar office space on the first floor is $1.10 per sf per month (Transcript Vol.1, p. 144) or, $13.20 per sf /year. (SJWC Exh. 1, Stein, p. 5) DRA recommends that the Commission order SJWC to re-negotiate its lease with its affiliate SJLC so that the rent is comparable to market rates.

B. SJWC Violated Section 851 By Transferring Properties Without Commission Approval

From July 1997 to April 2004, SJWC determined that five properties were no longer used and useful. The company then proceeded to transfer or sell the properties to non-utilities without filing Section 851 applications for Commission approval (DRA Exh. 1, p. 16, for a list of the properties). DRA has determined that at least two of the properties were inappropriately designated as no longer used or useful and could have been used for future expansion plans of SJWC:

a. Property Address: 555 West Campbell Avenue, Campbell (Lot# 276; Parcel # 305-24-051)

The following are excerpts from one of three appraisal reports submitted by SJWC in response to a Data Request by DRA [8]:

> On p. 5 of the appraisal report, it states:
>
> "This property is a satellite field office and yard for SJWC and previously served as the Campbell Water Company headquarters prior to the merger with SJWC. The property consists of one main office building of 1,512 sf, three auxiliary office and storage buildings (which total 2,100 sf) and two attached carport structures (of 1,615 sf). These building improvements are situated on a site of approximately 2.85 gross acres and have related water company site improvements (storage tanks, pumps and pumping infrastructure, etc.) . . . " (SJWC Exh. 7, p. 5)
>
> On p. 14 of the document, it states that:
>
> "In discussions with Geoff Bradley, Senior Planner with the City of Campbell, . . . it would not be out of the question (upon procurement of necessary municipal approval) to preserve the office as a separate site and allow continued use of such by a public or private entity. (This primarily relates to the site being used, in part, as such and the fact that under such a proposal, the property would largely be utilized as a conforming use, with a small 10,000 sf portion being non-conforming, but not inconsistent with the present use) . . . " (SJWC Exh. 7, p. 14)

Similar information is contained in the other two appraisal reports.

b. Property: Lot # 214 Blossom Hill Road, San Jose (Parcel # 464-45-057)

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[8] Exhibit SJWC-7: SJWC response to DRA DR RK-5: Complete Appraisal, Summary Appraisal Report … Property two-office/Yard & Accompanying Excess Land – 555 West Campbell Avenue, Campbell< Santa Clara County, California. Prepared by: Mr. Rick P. Smith and Mr. Eugene W. Madison. Effective date of valuation: December 19, 2001.

The following is from an appraisal report submitted by SJWC in response to a Data Request by DRA [9]:

> On p. v of the report, it states that the site is located in San Jose and is approx. 4.99 acres. The site improvements include Water pumping, storage and transfer facility. (SJWC Exh. 7, P. v)
>
> On p. I-8 of the appraisal report, it states that:
>
> The property is zoned R-1-B-6, residence District, which generally permits single family residences or one dwelling unit per lot. Additional permitted uses include educational facilities, golf courses, and small residential care facilities. Conditional uses requiring a Conditional Use Permit include country clubs, places of worship, child day care facilities, and public utility facilities (excluding corporation yards and warehouses) . . . " (SJWC Exh. 7, P. I-8; emphasis added)

Clearly, each of the above properties could have been used for future expansion needs of SJWC's space requirements, but instead were transferred to non-utilities by SJWC without prior authorization by the Commission in violation of Section 851.

C. SJWC Sold Two Properties Before They Were Classified As Non-Utility Plant

When utility property is determined to be no longer used and useful, it is removed from Utility Plant in Service. The plant is removed from rate base and does not earn a return on investment. SJWC sold the following properties to its affiliate SJLC before their operations department found them to be no longer used and useful, but did not remove the properties from Utility Plant in Service:

[9] Exhibit SJWC-7: DRA DR-5: Valuation Analysis, 4.99 Acres of land, Blossom Hill Road, san Jose, CA. Report prepared by The Reitman Group, 2470 El Camino Real, Suite 200, Palo Alto, CA 94306. September 1999.

a. Lot #276, S. First Street, Campbell

This property was acquired in 1980, was transferred to non-utility plant in April 2000 and was sold to SJLC in September 2000. However, the recommendation to remove it from Utility Plant in Service was made on April 13, 2004. (Transcript Vol. 2, P. 237; DRA Exh. 11, Memo dated 4/13/04)

b. Lot # 214, Blossom Hill Road, San Jose

This property was acquired in December 1959, was transferred to non-utility property in July 1997 and was sold to SJLC in December 1999. However, the recommendation was made to remove it from Utility Plant in Service on March 6, 2001, almost 2 years after the sale to SJLC. (Transcript Vol. 2, P. 238) As stated in Section 2b above, DRA has determined that this property was inappropriately determined as no longer used and useful because it could have been used for a public utility facility and for SJWC's future growth. (DRA Exh. 11, Memo dated 3/6/01)..

SJWC witness Jensen acknowledged that the prudency of the decision that a property is no longer necessary and useful can be made by SJWC. However, that decision is subject to Commission review. He also acknowledged that per Section 790 (e), the Commission retains the continuing authority to determine the use, useful, or necessary status of any and all infrastructure improvements and investments. (Transcript Vol. 2, p. 239).

Hence, DRA recommends that the Commission require SJWC to file Section 851 applications for the sale of the properties listed in DRA Exh. 1, P. 16 and determine the appropriateness of these transactions under Section 851. If the Commission determines that these properties were still necessary and useful, the Commission should void the transactions and fine SJWC for its violation of Section 851.

VI. RULE 1.1 VIOLATION

SJWC misled the Commission by failing to disclose the material fact that it had already purchased the 1265 Bascom Avenue building in May 2007, despite the fact that leasing space in the 1265 Bascom Avenue building was part of the Base Case and Alternative 1 as proposed by SJWC in its application.

Rule 1.1 of the Commission's Rules of Practice and Procedure states as follows:

> "Any person who signs a pleading or brief, enters an appearance, offers testimony at a hearing, or transacts business with the Commission, by such act represents that he or she is authorized to do so and agrees to comply with the laws of this State; to maintain the respect due to the Commission, members of the Commission and its Administrative Law Judges; and never to mislead the Commission or its staff by an artifice or false statement of fact or law."

VII. SJWC's Failure To Disclose A Material Fact Is A Rule 1 Violation

During the first day of evidentiary hearings in this proceeding on December 19, 2007, SJWC's witness Craig Giordano testified that SJWC had purchased the 1265 Bascom Avenue building in approximately May 2007. (Reporter's Transcript Vol.1, pp. 58-61) He also testified that SJWC has already completed the purchase of the Chicago Title Insurance building. (Reporter's Transcript Vol. 1, pp. 60-61) In other words, SJWC has gone ahead with implementing Alternative 2 prior to a Commission decision on this matter.

SJWC never informed the Commission, or DRA staff, about the purchase of the 1265 Bascom Avenue building at any time during this proceeding despite numerous opportunities to do so. For example, SJWC could have disclosed the purchase during discovery throughout the proceeding prior to hearings, during the last PHC in October 2007, or during DRA's last site visit in November 2007. Nor was this material fact disclosed in any of the supplemental testimony filed by SJWC's witnesses on May 7, 2007, the month the purchase of the property closed. In other words, SJWC had a seven month period from May 2007 to December

2007 to inform the Commission and DRA about the purchase of the 1265 Bascom Avenue building and failed to do so.

By failing to inform the Commission that it had already purchased the 1265 Bascom Avenue building, SJWC allowed this proceeding to go forward as if the Base Case and Alternative 1 were still realistic options. If DRA had this information, it would have requested that SJWC amend its application accordingly since neither the Base Case nor Alternative 1 remained realistic options given that both involve the lease of additional space at the 1265 Bascom Avenue building; options that are not possible unless SJWC leases from itself.

DRA anticipates that SJWC will argue that the failure to disclose this material fact was an omission on their part, and not intentional. In D. 01-08-019, the Commission found that Sprint PCS had violated Rule 1.1 even if it did not intentionally set out to deceive staff, "the results of its actions did have the effect of misleading the Commission." (D.01-08-019, p. 9) "The lack of direct intent to deceive does not, necessarily, however, avoid a Rule 1 violation." (D.01-08-019, p. 10) In fact, the intent to deceive merely goes to the weight to assign any penalty that may be assessed. (Decision 01-08-019, p. 10.)

DRA asserts that SJWC's failure to disclose material facts had the effect of misleading the Commission. It also had a substantive effect not only DRA's analysis, but on what the Administrative Law Judge (ALJ) and the Commission understood they were addressing in this proceeding. Such conduct by SJWC is misleading, even if unintentional, and results in a Rule 1.1 violation.

DRA notes that the Pub. Util. Code takes a dim view of attempts to mislead or deceive the Commission. For example, Section 2102 allows the Commission to seek injunctive relief against utility omissions and Section 2114 imposes a $500,000 fine for deliberate falsehoods. While DRA does not deign to speculate about SJWC's intentions to deliberately conceal its acquisition of the Bascom Avenue building from the Commission, it is indisputable that SJWC had a duty to disclose it had purchased the facility well before the hearings. SJWC's cavalier attitude about its obligations and its inadvertent disclosure during hearings made its analysis of options less a genuine search for alternatives than an ill disguised attempt to post hoc conjure up evidence to justify a *fait accompli.* Indeed, why have alternatives in an application if SJWC had no intention of pursuing any course besides the one it settled upon in May of 2007? In essence, what San Jose is seeking in this proceeding is the retroactive ratification of a decision it made eight months ago.

A. Penalties Should Be Imposed Upon SJWC For The Rule 1.1 Violation

The Commission's authority to impose penalties for SJWC's violation of Rule 1.1 is provided for in Public Utilities Code Section 701, which states that the Commission is "empowered to supervise and regulate every public utility in the State and may do all things . . . which are necessary and convenient in the exercise of such power and jurisdiction." (See also, Calif. Constitution, Article 12, Sec. 6.) The Commission is required by law to ensure that the provisions of the Constitution and statutes of this State affecting public utilities, the enforcement of which is not specifically vested in some other officer or tribunal, are enforced and obeyed, and that violations thereof are promptly prosecuted and penalties due the State therefore recovered and collected. (Pub. Util. Code, § 2101.)

Moreover, the Public Utilities Code further provides that:

> "Any public utility which violates or fails to comply with any provision of the Constitution of this state or of this part, or which fails or neglects to comply with any part or provision of any order, decision, decree, rule, direction, demand, or requirement of the commission, in a case in which a penalty has not otherwise been provided, is subject to a penalty of not less than five hundred dollars..., nor more than twenty thousand dollars ... for each offense." (Id., Sec. 2107.)

Decision (D.) 98-12-075, and Public Utilities Code Sections 2107 - 2108, provide guidance on the application of punitive fines.10 As stated in D.98-12-075, two general factors are considered in setting fines: (1) the severity of the offense and (2) the conduct of the utility. In addition, the Commission considers the financial resources of the utility, the totality of the circumstances in furtherance of the public interest, and the role of precedent. (D.98-12-075, pp. 34-39.) A fine might be a penalty of not less than $500, nor more than $20,000, for each offense, with every day of a continuing offense a separate and distinct offense. (Public Utilities Code Sections 2107 and 2108.)

In this case, DRA recommends that the Commission impose a penalty of $140,000 against SJWC for its continuing Rule 1.1 violation. As stated above, SJWC had approximately seven months from the time it bought the 1265 Bascom Avenue building to inform the Commission, and DRA staff, of this material fact and failed to do so. This results in a continuing Rule 1.1 violation. DRA could request a fine for every day of the continuing offense, which constitutes a separate and distinct offense under Sections 2107 and 2108, but instead DRA requests the maximum fine of $20,000 for each month SJWC failed to inform the Commission about the purchase. Since SJWC purchased the 1265 Bascom Avenue building in May 2007, DRA requests a $20,000 penalty per month for the seven months from June 2007 through December 2007 amounting to a total fine of $140,000. DRA believes that this proposed penalty is more than reasonable and will deter SJWC from engaging in similar conduct in the future.

VIII. CONCLUSION

The Commission should deny SJWC's application for the sale of its Main Office, purchase of a new Main Office building, and purchase of the 1265 Bascom

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[10] D.98-12-075 indicates that the principles therein distill the essence of numerous Commission decisions concerning penalties in a wide range of cases, and the Commission expects to look to these principles as precedent in determining the level of penalty in a full range of Commission enforcement proceedings. (Mimeo., pp. 34-35.)

Avenue building in San Jose (Alternative 2) where it is currently leasing space from its affiliate. The evidence shows that SJWC's need for additional space to accommodate current employees and future growth could be easily solved by remodeling the current Main Office and leasing an additional 3,980 sf of space at 1265 Bascom Avenue from its affiliate SJLC (Base Case). The evidence proves that the Base Case is the least cost option based on the NPV analysis of future revenue requirements.

In fact, the evidence proves the Base Case provides more space than is actually necessary to accommodate the six employees hired after its last GRC and future growth. During evidentiary hearings, SJWC confirmed that, separate and apart from the Base Case, it will be freeing up 2,850 sf of additional space in its 1251 Bascom Avenue building as a result of moving store items to its Will Wool building in San Jose, which is under construction. Upon subtracting the 2,850 sf of space from the 3,980 sf of space requested in SJWC requested in the Base Case, it becomes clear that SJWC only needs to lease an additional 1,130 sf of space at 1265 Bascom Avenue to accommodate the six new employees hired after its last GRC and future growth.

DRA recommends that SJWC be subject to penalties for a Rule 1.1 violation. SJWC misled the Commission by failing to disclose the material fact that it had purchased the 1265 Bascom Avenue building as early as May 2007. DRA discovered for the first time on the first day of evidentiary hearings (commencing on December 19, 2007) that SJWC had already purchased the 1265 Bascom Avenue building in May 2007 when a SJWC witness testified to that effect during cross-examination by DRA. SJWC had numerous opportunities to disclose this material fact to the Commission and DRA, for example during discovery throughout the proceeding prior to hearings, amending its application during the last PHC in October 2007, or during DRA's last site visit in November 2007, but failed to do so. That same witness also testified that SJWC has completed the purchase of the Chicago Title Insurance building as well. In essence, SJWC has gone ahead with implementing Alternative 2 prior to a Commission decision on this matter.

DRA expended innumerable hours of time and energy analyzing all three alternative in SJWC's application, Base Case, Alternative 1 and Alternative 2. The Base Case involves the lease of 3,980 sf of additional space and Alternative 1 involves the lease of the entire first floor in the 1265 Bascom Avenue building. SJWC's purchase of the building as early as May 2007 obviously calls into question whether the Base Case and Alternative 1 are even viable options unless SJWC plans on leasing the space from itself. At a minimum, SJWC should have amended its application to reflect reality, rather than disclose this matter during hearings.

DRA asserts that SJWC's failure to disclose this material fact had the effect of misleading the Commission. It also had a substantive effect not only on DRA's analysis, but on what the ALJ and the Commission understood they were addressing in this proceeding. Such conduct by SJWC is misleading, even if unintentional, and results in a Rule 1.1 violation. Penalties should be imposed to deter SJWC from engaging in this type of behavior in a future proceeding.

Based on the above, DRA recommends that the Commission reject Alternative 1 and Alternative 2 thereby denying SJWC's request to sell its Main Office, purchase the new Chicago Title Insurance building, and purchase the 1265 Bascom Avenue building. The Commission should issue an order voiding SJWC' sales transaction with its affiliate SJLC for the 1265 Bascom Avenue building. Given that SJWC has already implemented Alternative 2, the Commission should disallow the costs of purchasing the new Main Office (Chicago Title Insurance building) and the costs of purchasing the 1265 Bascom Avenue building. The Commission should order SJWC to lease only 1,130 sf of space on the first floor of the 1265 Bascom Avenue building for the market rate of $13.20 per sf per year, and only allow SJWC to recover in rate base the costs of renovating the 1251

Bascom Avenue building and leasing the additional 1,130 sf of space in the 1265 Bascom Avenue building.

Should the Commission allow SJWC to purchase the 1265 Bascom Avenue building, DRA recommends that the affiliate transaction rule of "lower of cost or market" be applied for the purchase price of this building and the building acquisition cost be limited to $2.7 million (original cost of $3.6 less .9 million for depreciation) which is the book cost of its affiliate SJLC.

Should the Commission allow SJWC to continue to lease the second floor of the Bascom Avenue building from its affiliate SJLC (for example if its purchase of 1265 Bascom Avenue is void), DRA recommends that the Commission order SJWC to renegotiate the lease with its affiliate since it has been paying almost three times the market rent for space in the area.

DRA also recommends that the Commission order SJWC to file Section 851 applications for the five properties that it transferred to its affiliate SJLC without Commission authorization. SJWC's failure to file Section 851 applications for these transfers is another indication of its total disregard for Commission statues, policies and procedures.

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DRA trusts that the Commission will adopt its above-mentioned recommendations and act accordingly. Any other decision would be rewarding SJWC for its lack of candor and concealing its various real estate transactions from the Commission.

Respectfully submitted,

/s/ MARIA L. BONDONNO

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January 25, 2008

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of **OPENING BRIEF OF THE DIVISION OF RATEPAYER ADVOCATES** in **A.07-01-035** by using the following service:

[X] **E-Mail Service:** sending the entire document as an attachment to an e-mail message to all known parties of record to this proceeding who provided electronic mail addresses.

[ ] **U.S. Mail Service:** mailing by first-class mail with postage prepaid to all known parties of record who did not provide electronic mail addresses.

Executed on January 25, 2008 at San Francisco, California.

/s/ NANCY SALYER
Nancy Salyer

N O T I C E

Parties should notify the Process Office, Public Utilities Commission, 505 Van Ness Avenue, Room 2000, San Francisco, CA 94102, of any change of address and/or e-mail address to insure that they continue to receive documents. You must indicate the proceeding number on the service list on which your name appears.

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